RWANDA BANKERS' ASSOCIATION

"Together for a better banking environment"

STATE OF THE BANKING INDUSTRY REPORT 2024

JULY 2024

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The State of the Banking Industry report 2024

The State of the Banking Industry Report (SBIR) is an annual publication of the Rwanda Bankers' Association (RBA) Research Centre. The RBA Research Centre was established in 2023 as a platform for positioning the financial sector to be a key driver of the economy's development aspirations. The setting up of the Research Centre was underpinned by the need to anchor market developments on evidence based insights. The Centre offers an array of research papers and commentaries, and promotes dialogues on critical policy issues by way of convening conferences and workshops. The pursuit of depth and clarity in the Centre's research is a testament of the commitment to transform the Rwandan banking industry through being at the frontier of knowledge that grounds data-driven insights and forward-thinking solutions.

About this Report

The State of the Banking Industry Report (SBIR) is aimed at contributing to the understanding of the banking industry in Rwanda. This is the first issue of the SBIR. The knowledge repository on the Rwandan banking industry is as diverse as the number of interested agencies that have an interest in the economy generally and the financial sector specifically. The thrust of each analysis is underpinned by the intent to offer insights for varied stakeholder of the Rwandan banking industry, in the process proffer diversity of perspectives. This report is therefore contributory to the diversity of viewpoints, therefore complementary to the National Bank of Rwanda (NBR), market analysts, rating agencies, international agencies, commercial banks, and the academic community.

The RBA Research Centre compiles a dataset from various secondary sources that forms the bedrock of its analysis including the IMF, World Bank, National Bank of Rwanda, National Institute of Statistics Rwanda. The assessment of financial performance of the banking industry is based in the dataset assembled from financial statements from each of the commercial banks operating in Rwanda but analysed at industry level.

This inaugural issue of the Banking Industry Report has benefited from discussions, comments and suggestions by external reviewers from banks, analysts and academic researchers. However, the analysis and inferences are entirely those of the report's authors and not attributable to those who commented on it. The report has benefited from the partnership between RBA Members and Access to Finance Rwanda (AFR) that facilitated the establishment of the RBA Research Centre.

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Foreword

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The Rwanda Banking Industry is on a solid footing. As the Rwanda Bankers' Association inaugural State of the Banking Industry Report (SBIR) shows, the industry showcases growth that is supportive of the economy's post-shock recovery, profitability that is bolstered by high quality assets, and efficiency that reveals the benefits of investing in technology that underpins innovations in products and operations.

The thrust of the SBIR is the argument that the fortunes of the banking industry and those of the rest of the economy are intertwined. The growth trajectory of the collective assets of the industry as a share of the economy's output manifest the benefit of embedding finance as an engine of development.

The perspectives in the SBIR will undoubtedly provide a holistic understanding of the Rwandan banking industry. It complements the analytical work by others that tend to have a focus on either stability or financial performance, two aspects that are obviously important but may not give a complete picture unless they are interacted with the broader expectations of the varied economic agents.

As the first section of the SBIR argues, there is a nexus between growth in banking and reduction in informality. The growth of banking industry assets reveals the ease of credit access that buttresses a gradual shift of the economy away from informality as enabled by the banking system.

The rest of the SBIR highlights an implicit trinity of objectives. First is that the profitability of the banking industry is accompanied by a conservative risk attitude. Two, because of the industry's aforementioned risk demeanour, there is a low and generally declining levels of non-performing loans a share of gross loans, reflecting the good quality of assets. Three, the market is reflective of an evolving landscape with the corresponding competition dynamics arising from mergers and acquisitions.

One could infer from the SBIR that the prospects of the Rwandan Banking industry are positive and will continue to be shaped by emerging opportunities and risks linked to climate change and the embracing of technology.

It is my hope that our stakeholders will find the SBIR insightful.

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Abbreviations

AFR: Access to Finance Rwanda

CBR: Central Bank Rate

ESG: Environmental Social and Governance

GDP: Gross Domestic Product

HHI: Herfindahl-Hirschman Index

KIFC: Kigali International Financial Centre

MPC: Monetary Policy Committee

NBR: National Bank of Rwanda

NPLs: Non-Performing Loans

RBA: Rwanda Bankers' Association

RWF: Rwandan Franc

SBIR: State of the Banking Industry Report

USD: United States Dollar

Executive Summary

- The Rwandan banking industry has over the past decade exhibited general stability and steady growth. The current state of the banking industry is backed by strong post COVID-19 economic recovery. The extent to which the Rwandan banking industry is increasingly embedding itself to the economy is revealed by not just the robust growth in total assets but more in the evolution of the assets as a share of GDP. Noteworthy, the assets of the banking industry in Rwanda as a share of GDP are ahead of those of Uganda, Tanzania and Nigeria but are less than those of Kenya and South Africa.

- The evolution of the assets growth speaks to the progressive deepening of the bank-led financial system. The deepening trend comes with the benefit of a gradual shift of the economy from informal to formal. The improvement of financial market conditions therefore raises aggregate size of the formal economy.

- The banking industry has over the past decade registered consistent growth in profitability. While the profitable stance is aligned to the generally robust economic performance over the period – except during the shock associated with the COVID 19 – the post shock period has notably seen a pick in profitability parameters of return-on-assets and return-on-capital.

- Underlying the profitability trend are three aspects that reveal the generally cautious approach across the industry that is accompanied by continued investment in efficiency enhancement. First, net interest margins have been stable in the back of a gradually declining yields on advances. Second, the banking system has over the past three years exhibited a leaning towards more liquidity as signified by the declining trend of the loan to deposit ratio. Third, banks' cost of funding as reflected in the cost of deposits that over the past two years have been on a gradual decline on the back of stable net interest margin. In the process, the industry's cost to income ratio has been on a noticeably steady declining trend.

- The risk-taking attitude of the banking industry is attuned to sufficient consciousness to boosting shareholders value without jeopardizing systemic stability. The low and generally declining levels of non-performing loans (NPLs) as a share of gross loans reflects the good quality of the industry's assets. With a comfortable spread between the lending rate and less risky government securities, and given the low level of NPLs, banks are sufficiently incentivized to maintain a positive lending position to the private sector.

- In pursuit of the stability agenda, the banking industry has consistently matched the foreign exchange assets with foreign exchange liabilities, with sufficient buffer to allow for the market to absorb any shocks arising from external imbalances. The challenges to market stability that can potentially arise from the dynamics around the domestic and foreign currency assets and liabilities interplay in the banking industry are obviated by the adequate capitalization of banks, with sufficient capital buffers.

- The current state of the banking industry in Rwanda reflects an evolving landscape shaped by the strategic objective of the markets players responding to competition dynamics. The combined balance sheet size of the top three banks as a share of the industry balance sheet has been on the decline. Similarly, Herfindahl-Hirschman Index (HHI) shows that the market is becoming less concentrated even as mergers and acquisitions happen. While the extent of market concentration is lesser even on the back of mergers and acquisitions, the small banks : big banks dichotomy is still at play in the understanding of possible systemic risks that may arise from clusters of banks.

- The growth trajectory of the banking industry assets as a share of GDP will likely be sustained, cognisant of the positive outlook of the Rwandan economy with regard to real output growth. The outlook of continued profitability will likely shape expectation on the benefits of a stable and profitable banking industry. The matching of the shareholder value to customer benefits is increasingly being embedded in the market dynamics.
- The balance between the compelling need to protect the assets quality through the cautious risk-taking and the essence of allocating credit in line with the economy's needs is vital. It is critical though to determine the threshold below which the decline in loans to deposition (a proxy for preference of liquidity to profitability) and a similar trend in yield on advances (pointing to the increase of advances to less riskier assets) will be counterproductive. .

Chapter 1: Introduction

The Rwandan banking industry has over the past decade exhibits general stability and steady growth. The intricate interaction of the banks with the non-financial sector point to a dynamic sector that responds to both the demands of enterprises and households adjusting to developments in the economic cycle, and a responsive regulatory environment by the National Bank of Rwanda (NBR) meant to entrench market stability.

The current state of the banking industry is backed by strong post COVID-19 economic recovery. Following the real output shrinkage of 2020 has been a strong growth rebound that has taken the economy back to its trend **(Figure 1: A)**. As banks keenly watch the economy displaying stable real quarterly growth post 2021 **(Figure 1: B)**, the inevitable risk management attitude has underpinned an element of caution as it remains to be seen whether the observed growth stability is persistent.

Figure 1: A - Real GDP Growth

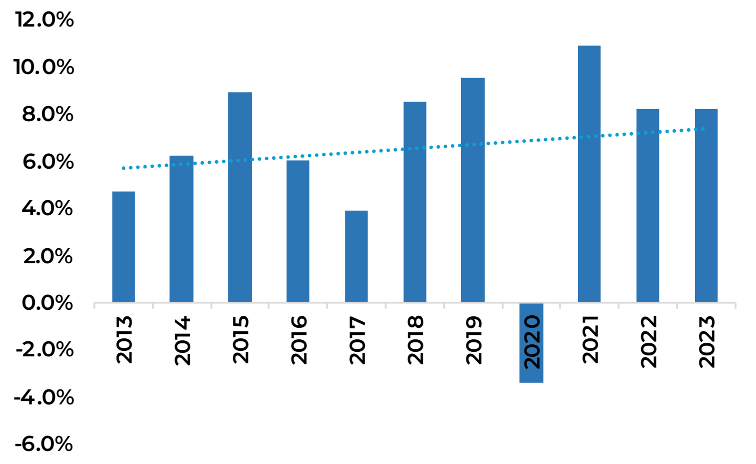
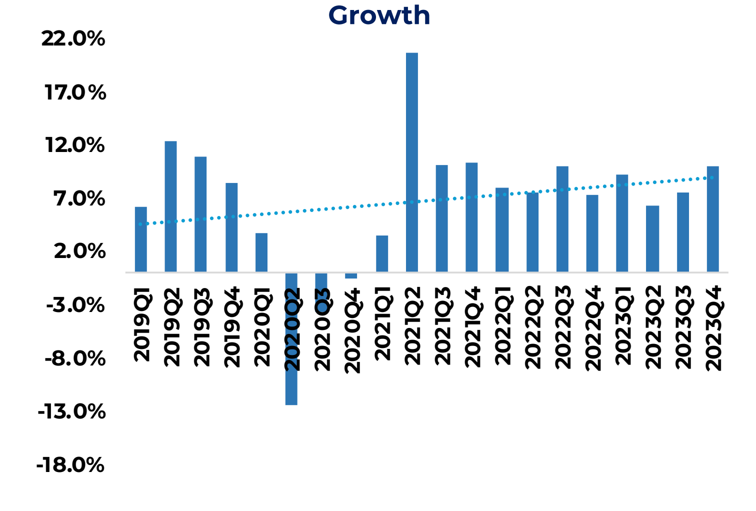


Figure 1: B - Rwanda's Quarterly Real GDP Growth



Source: NISR

The extent to which the Rwandan banking industry is increasingly embedding itself to the economy is revealed by not just the robust growth in total assets but more in the evolution of the assets as a share of GDP (Figure 2: A). Comparatively, it is noteworthy that the assets of the banking industry in Rwanda as a share of GDP are ahead of those of Uganda, Tanzania and Nigeria but are less than those of Kenya and South Africa (Figure 2: B)

Figure 2: A - Banking Industry Assets

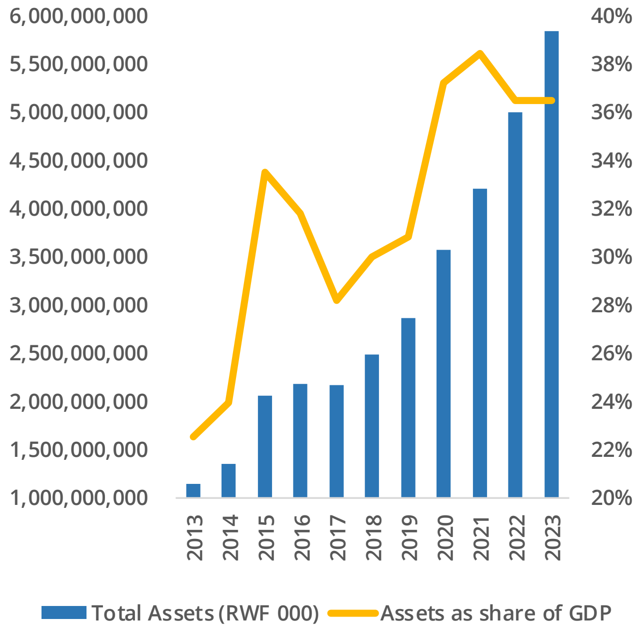
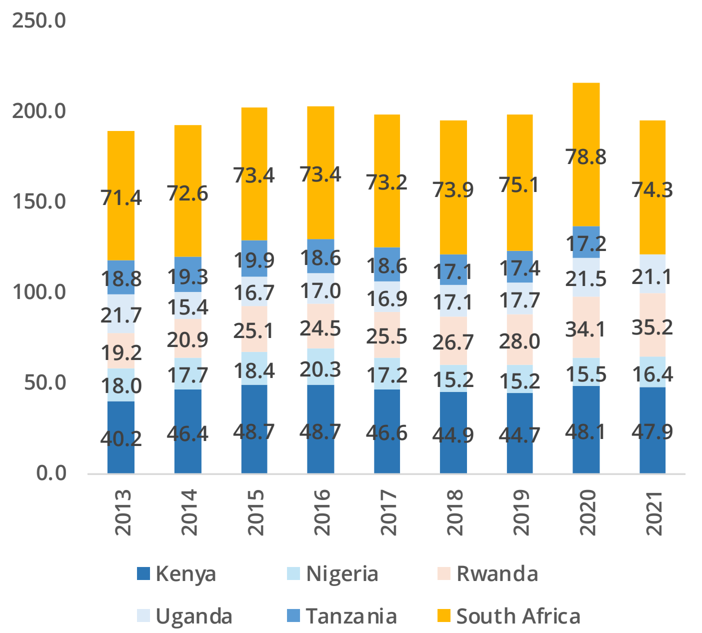


Figure 2: B - Banking Assets (% of GDP)



Source:* *Dataset from Commercial Banks, IMF, and World Bank Global Financial Development; *Assets Figures for 2023 are as at end of September 2023

The positively trend of Rwanda's banking industry assets as a share of GDP implicitly points to the economy's strides in financial depth has an influence on the choices of firms and individuals to towards operating formally than informally. As is well understood[1] , informal firms and households are often credit-constrained and unable to access credit markets; but as financial market conditions improve, the opportunity cost of informality increases, encouraging a shift towards formal activity and raising the aggregate size of the formal economy.

While agriculture plays a significant role in the Rwandan economy, accounting for about 25.0% of the total output, its share of credit from the banking industry is small **(Table 1)**. Cognisant that a bulk of agriculture in Rwanda is small-scale and informal[2] , creative initiatives by the banking industry to tap into the sector's opportunities will be supportive of its formalization. The banking industry credit to other sectors, especially manufacturing services, trade and other services is strong. That provides an avenue for banks to promote intra-sector linkages in a manner that mainstreams agriculture value chains.

1 See for Instance Capasso, S. Franziska Ohnsorge, F and Yu, S. (2022)." Informality and financial development: A literature review", The Manchester School, Vol 90 (5), pp. 587 – 603.

2 According to Access to Finance Rwanda (AFR) Finscope 2020, about 80.0% of the adult population is engaged in agriculture, 90.0% of whom are practicing subsistence farming and only 10.0% engaged in commercial farming [Enhancing Inclusive Agriculture Finance in Rwanda: A path to the rapid transformation of the sector – Access to Finance Rwanda (afr.rw)]

Table 1: Bank's Outstanding Loans by Sector					
Activity Sector	**Loans (FRW Billion)**			**Annual Change**	
	Jun-21	Jun-22	Jun-23	% Change 21/22	% Change 22/23
Consumer Loans	361	406	627	12.5	54.5
Agricultural & Livestock	30	24	34	-20.2	39.8
Mining	1	1	0	-26.3	-31.0
Manufacturing	304	366	411	20.3	12.3
Water & Energy	116	119	178	2.7	49.7
Public Works	195	209	257	7.2	23.0
Residential Properties	386	490	527	26.7	7.7
Commercial Properties	258	272	269	5.6	-1.4
Trade	383	440	548	14.9	24.5
Hotels	268	314	259	17.0	-17.5
Transport & Communication	276	341	366	23.6	7.5
Financial Services	7	9	29	20.7	227.7
Other Services	144	178	211	23.5	18.9

Source: National Bank of Rwanda

As banks in Rwanda pursue their individual objectives, the collective outcomes point towards industry that supports the economy's development aspirations. The two-way interaction between banks and the other sectors of the economy is facilitative of the causal relationship that runs from financial systems' development supporting the reduction of informality.

The causality could run in reverse such that measures targeting the reduction of informality end up strengthening the financial system. Such deepening crucially depends on complementary policies such as the strengthening of regulatory frameworks, supporting increased competition and being amenable to market openness.

Contextualizing the state of play when comparing banking industry assets as a share of GDP, **Figure 3** highlights aspects that are supporting of the strategic thrust of embedding banking in the economy.

- Take the case of the two big economies in the African context with nominal GDP levels surpasing USD 380 billion in 2023 **(Figure 3: A)** but with notable differences in the share of bank assets to GDP. The South African economy, with a nominal GDP of USD 380 billion but whose banking industry assets are consistently above 70.0% **(Figure 2: B)** has a higher per capita income of USD 6,190 compared to Nigeria with a higher nominal GDP of USD 390 billion and a banking industry whose assets as a share of GDP is in the low around 20.0% and a per capita GDP of USD 1,755 **(Figure 3: B)**.
- The East African region confirms the observation that banking industry assets as share of GDP matter, without necessarily ascribing a causal connection to Per capita GDP. Kenya – the biggest economy in the region – had a nominal GDP of USD113 billion and its banking industry assets as a share of GDP are approaching 50.0%. and a per capita income of USD 2,188 in 2023.
- While Tanzania and Uganda have higher nominal GDP levels than Rwanda, their banking industry assets as a share of GDP are less than 20.0% and Rwanda's share over 35.0%; with the per capita income of these three economies being below USD1,400, it is clear that Rwanda has headroom in leveraging its improving financial depth for the benefit of the wider economy.
- With credit being the biggest component of the banks' assets, the extent to which financial depth is supportive of consumption and investment the Rwanda banking system will contribute towards not just bosting the economy's output but also income per capita.

Figure 3: A - Nominal GDP (USD Billions) - 2023

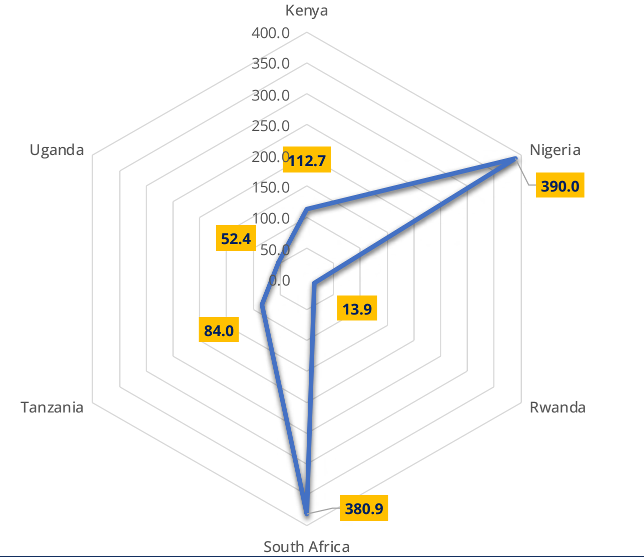
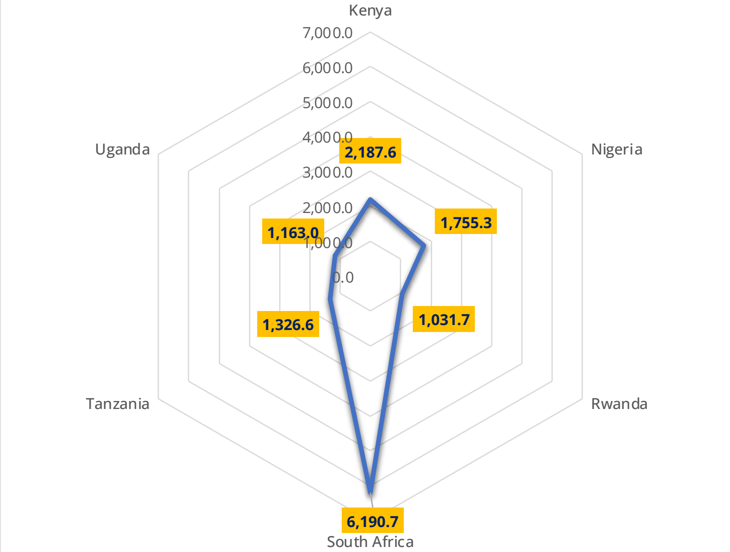


Figure 3: B - GDP Per Capita (USD Current Prices) - 2023



Source: IMF World Economic Outlook Database

The above background sets the scene upon which the state of the banking industry in Rwanda for 2024 is outlined. It underpins the context for understanding the interaction between the market players, the regulatory environment, customer and shareholder expectations, and how the interactions feed into banks 'financial performance. The analysis in the SBIR goes beyond seeing financial performance as an end itself but as consequential to the interactive process of the banks and the economy.

Chapter 2: Profitability Backed by a Cautious Business Approach

The banking industry has over the past decade registered consistent growth in profitability **(Figure 4: A)**. While the consistently profitable stance is aligned to the generally robust economic performance over the period – except during the shock associated with the COVID 19 – the post shock period has notably seen a pick in profitability parameters. The average return-on-equity that has been stable in the 10.0% - 15.0% range over the period 2014 – 2020 spiked to 21.5% by September 2023. For the corresponding period, the average return-on-assets that were stable in the 1.7% - 2.3% range rose to 4.7% **(Figure 4: B)**.

Figure 4:A- Banking Industry Profit

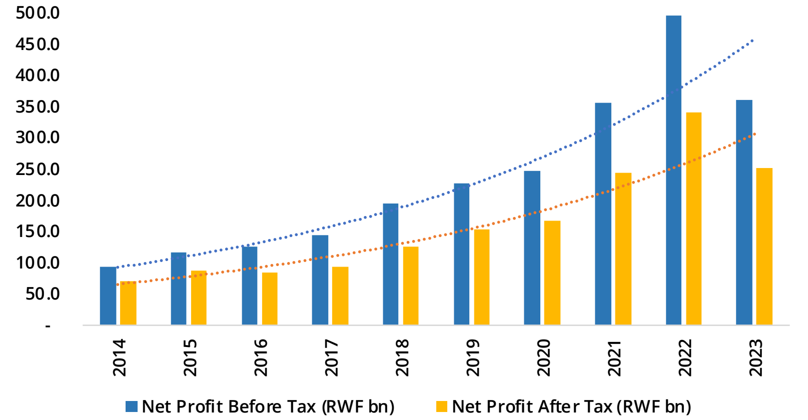
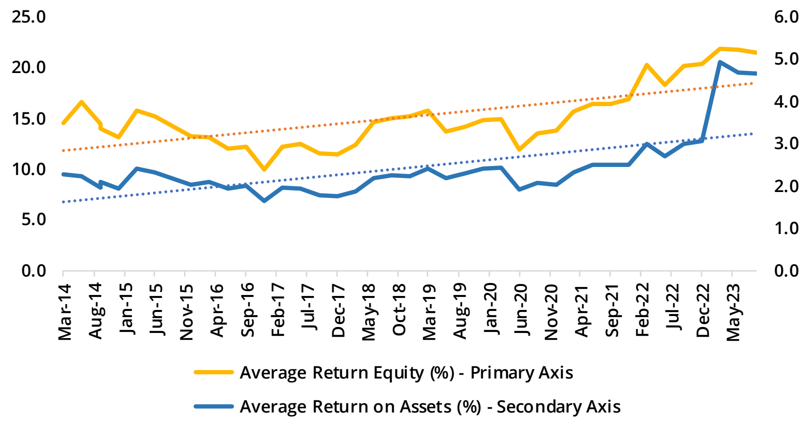


Figure 4:B - Financial Returns



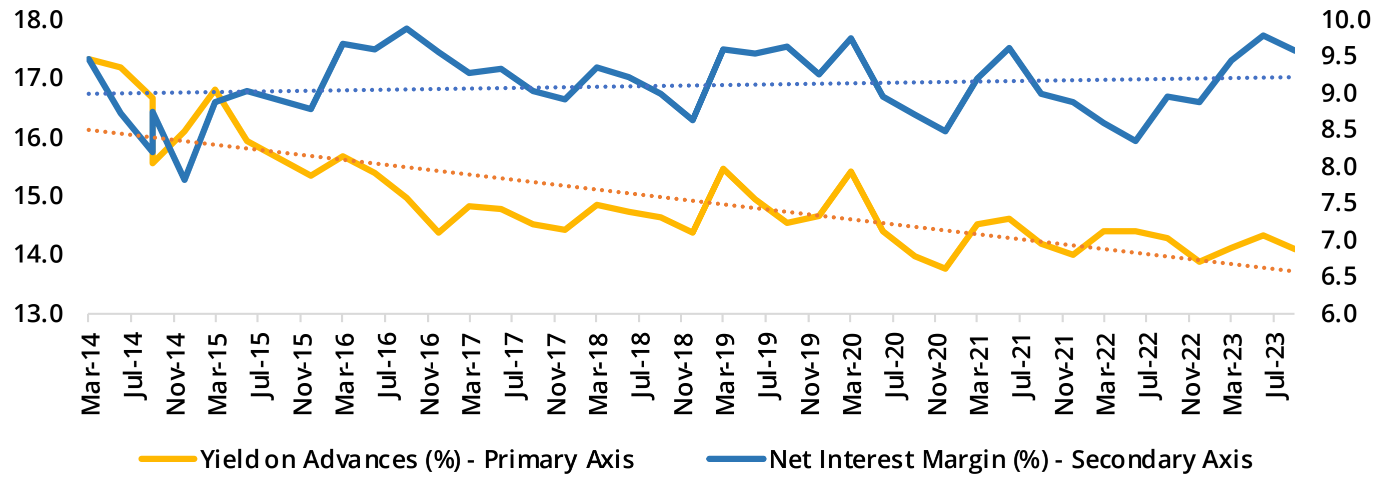
Source: RBA Data from all Commercial Banks

Underlying the profitability trend are three aspects that reveal the general cautions approach across the industry that is accompanied by continued investment in efficiency enhancement.

The first aspect is that while net interest margins have been stable in the 8.0% - 10% range, yields on advances have over the past decade been on a declining trend from 17.3% in March 2014 to 11.4% in September 2023 **(Figure 5)**.

The increase in profitability over time on the back of a stable net interest rates margin points to the steady growth in advances, tying to the observation in Section 1 of the noticeable growth trajectory of the banking industry assets. The declining average lending rate of the banking industry portfolio, represented by the yield on advances, points to the banks' approach of increasing their advances to less riskier assets.

Figure 5: Yields & Margins



***Source:** RBA Data from all Commercial Banks*

The second aspect is that the banking industry is leaning towards being more liquid than being more profitable. There is a strong negative association between the liquid assets as share of deposits and loans as a share of deposits **(Figure 6:A)**. That implies that the more the deposits are converted into loans the lower the general liquidity of banks. Therefore, the lower the loans/deposit ratio the more the liquidity in the banking system.

The gross loans/gross deposits ratio during the post COVID-19 period has been declining, being about 94.0% as at September 2021 and plummeting to about 82% by September 2023 **(Figure 6:B)**. This is the exact opposite of the 2014 – 2016 trend that was followed by a stable loans/deposit ratio until 2020. The present trend is another pointer to the cautious attitude in the market, even amidst growing profitability.

Figure 6:A - Association Between Liquid Assets/ Total Deposits (%) & Gross Loans / Total Deposits (%) - (2014 - 2023)

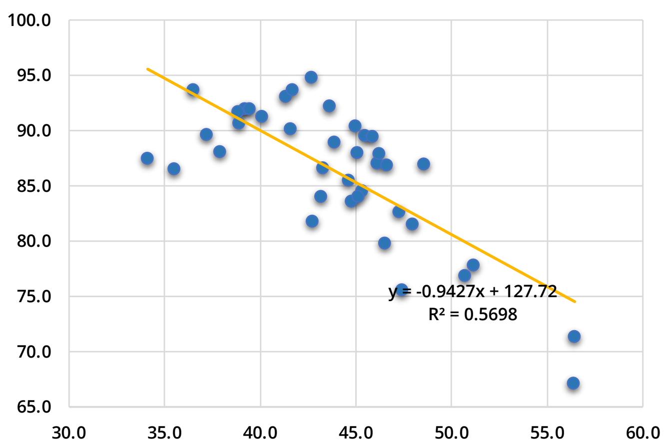
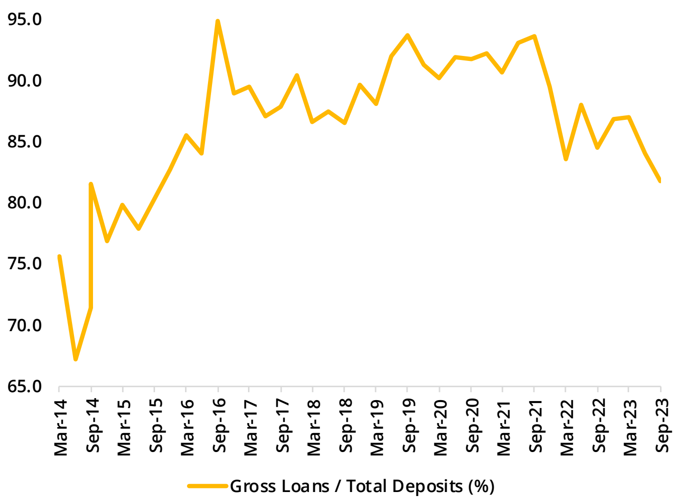


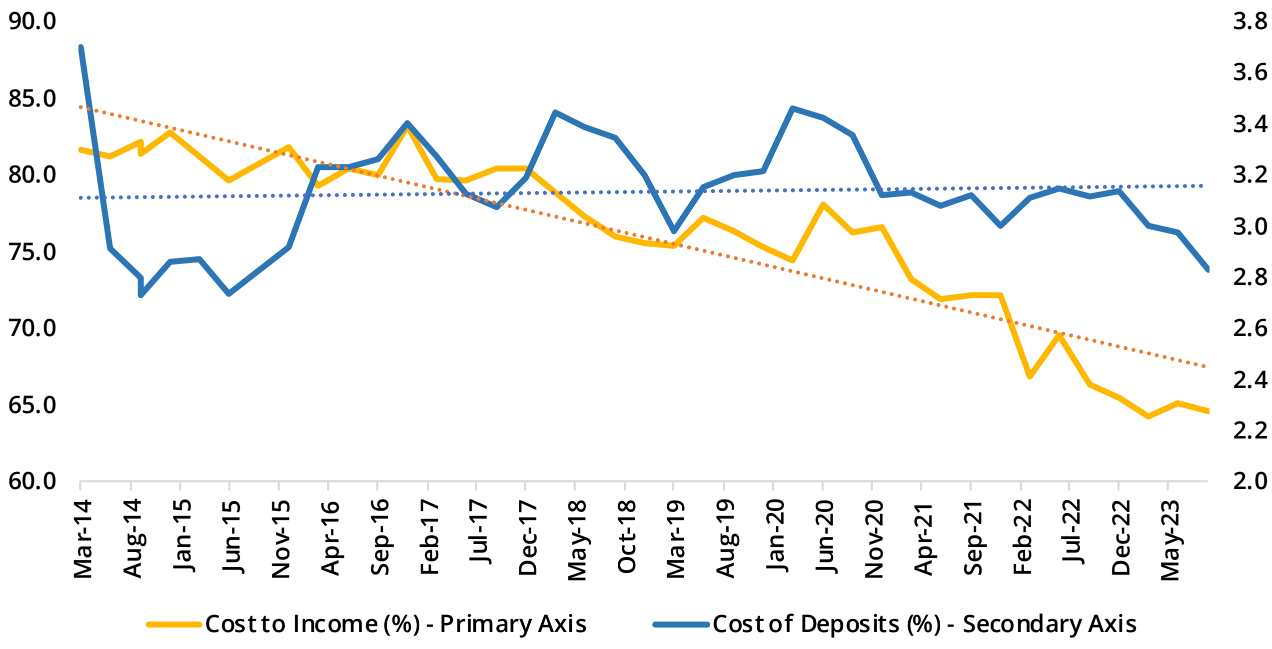
Figure 6:B - Gross Loans / Total Deposits (%)



***Source:** RBA Data from all Commercial Banks*

The third aspect is that banks' cost of funding as reflected in the stable cost of deposits that over the past two years have been on a gradual decline on the back of stable net interest margins, the industry's cost to income ratio has been on a noticeably steady declining trend **(Figure 7)**.

Figure 7: Cost of Deposits & Cost to Income Ratio



***Source:** RBA Data from all Commercial Banks*

Banks in Rwanda have taken a holistic approach to Fintech, cognisant that it presents a transformative opportunity to revolutionize the financial services sector, promote financial inclusion, and drive economic development. That is against the backdrop of Fintech being on the rise across Africa, with over USD2 billion invested in the sector in 2021[3] .

The Fintech aspirations of the banking industry is driven by the government of Rwanda's ambition to establish itself as a regional financial hub. Initiatives such as the setting up of Kigali International Financial Center (KIFC) are part of the efforts to create a conducive business environment. The government's five-year strategy[4] is aimed at holistically support the Fintech ecosystem in the country as a way of optimizing of the potential it holds for economic growth and socio-economic transformation.

Underpinning the declining cost to income ratio are investments that banks have been making over the years in terms of streamlining operations with a view to continuously improve on efficiency. At the core of the efficiency gains is the integration of financial technology (Fintech), not just in support of operations but also increasingly product design and offering.

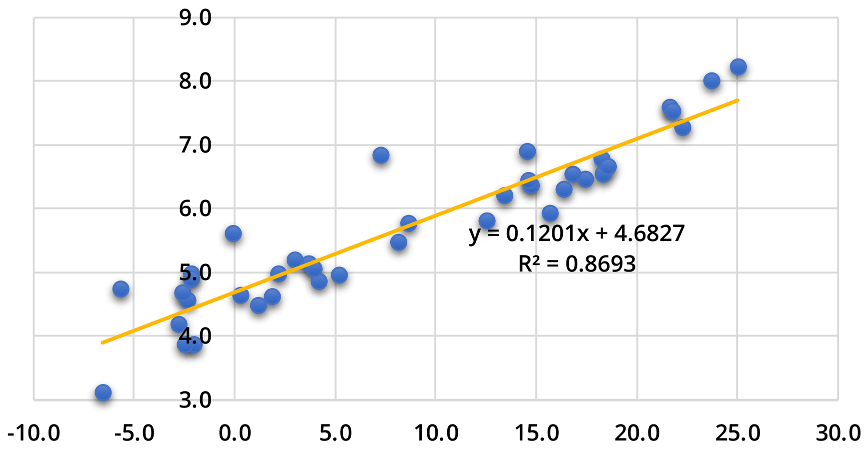
3 https://traide.org/activities/rwanda-fintech-sector-challenges-and-opportunities-2

4 https://www.minict.gov.rw/index.php?eID=dumpFile&t=f&f=41306&token=d582a81725e7b8289f1579fd34e9dbc40b8ad087

Chapter 3: Asset Quality Incentivising Private Sector Credit Growth

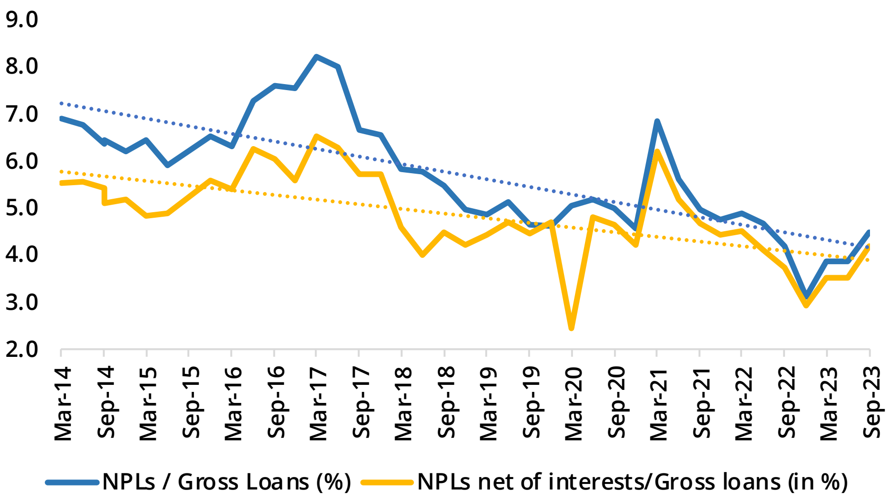
The risk-taking attitude of the Rwanda banking industry is attuned to sufficient consciousness to boosting shareholders' value without jeopardizing systemic stability. As argued in Chapter 2 and revealed in the declining yield on advances, the industry has a proclivity for less risky assets. Further, there is an endeavour to ensure that there is a healthy provision coverage in line with the NBR requirements. That is why there is a strong positive association between provision for doubtful debts as a proportion of core capital and non-performing loans (NPLs) as a proportion of gross loans **(Figure 8: A)**. Noteworthy, the low and generally declining levels of NPLs as a share of gross loans reflects the good quality of the industry's assets **(Figure 8: B)**.

Figure 8:A - Assocoation between Provision for Doubtful Debts/Core Capital (%) & NPLs / Gross Loans (%) - (2013 - 2023)



Source: RBA Data from all Commercial Banks

Figure 8:B - Asset Quality



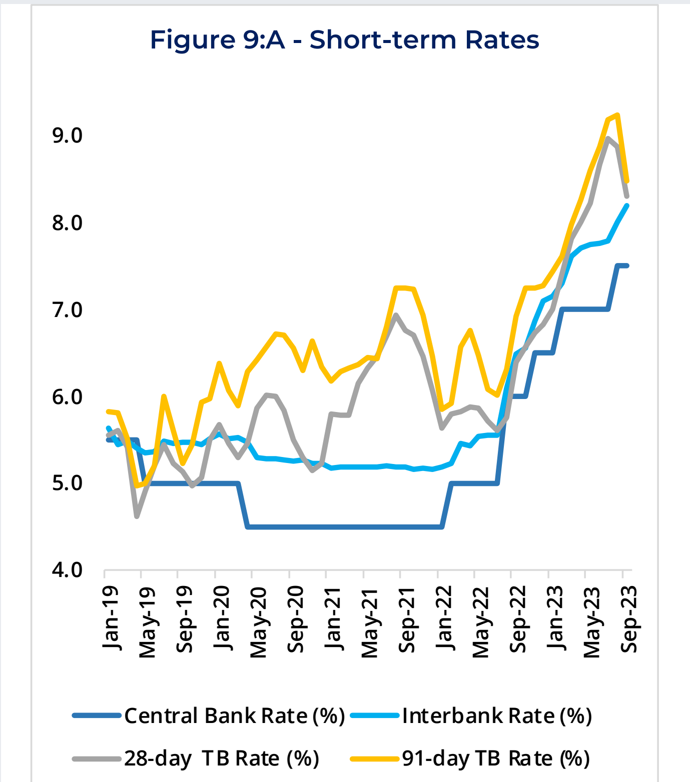
Underlying the foregoing developments in asset quality is a banking industry adjusting to expectations of the macroeconomic policy approach – especially the NBR's Monetary Policy Committee (MPC) – towards entrancing macroeconomic stability. The MPC is focused on the medium term year on year inflation target of 5% with a 2.0% - 8.0% band. The spike in inflation from a low of -0.9% in September 2021 to a pick of 21.6% in December 2022 has been accompanied by appropriate tightening of monetary policy.

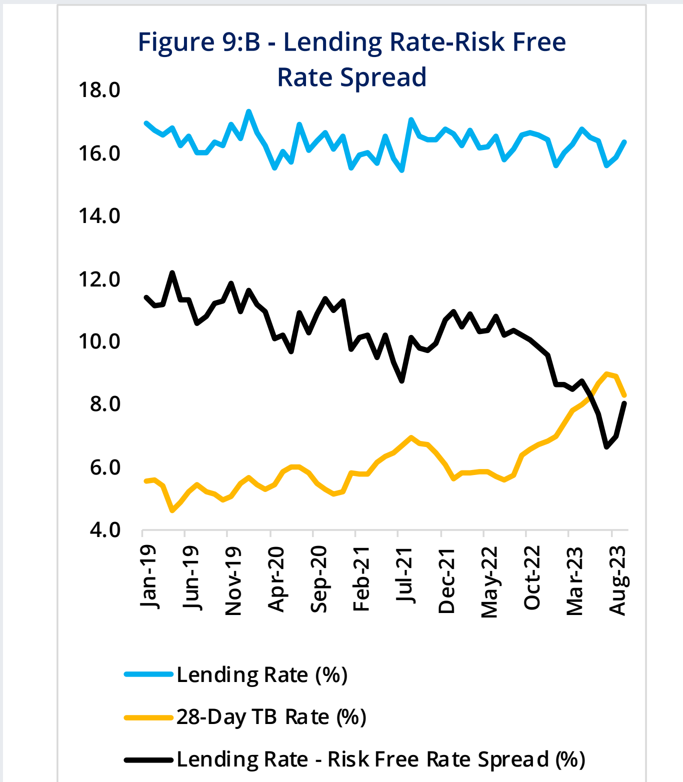
The MPC's change of policy stance from accommodative to tight is signaled by the increase in the Central Bank Rate (CBR), with a corresponding effect of aligning the short-term interest rates **(Figure 9: A).** Banks' lending rates have generally been sticky in the 15% - 17% range even under a tight monetary policy stance **(Figure 9: B)**. This is accompanied by generally stable deposit rates, as a consequence, a stable net interest margin, as noted in **Figure 5**.

With a comfortable spread between the lending rate and less risky government securities, and given the low level of NPLs that reflects good quality assets in the banking system[5], banks are sufficiently incentivised to maintain a positive lending position to the private sector **(Figure 10).** Therefore, the market outturn corresponding to the current monetary policy stance allows banks to play a role in entrenching the economy's emergent recovery.

Over the past decade, private sector credit has expanded at double digit rates – except in 2016. This is positive for the economy given that there is a strong causal relationship between private sector and the economy's gross capital formation[6]. Therefore, the current monetary policy stance is supportive of sustained credit growth without compromising on macroeconomic stability.

As private sector credit growths sustained a positive trend, the challenges associated asset quality in the case of Rwanda remain subdued, unlike in many markets in Africa where the issue of NPLS has been a challenge. As a recent IMF study confirm[7], sub-Saharan Africa (SSA) has over the past decade recorded high levels of NPLs in the banking system, their ratio as a share of gross loans exceeding 10% on average since the mid-2010s. The strategic approach taken by banks in Rwanda to sustain the asset quality in the banking industry is three pronged – proactively manage the assets to obviate deterioration, continuously fine-tune resolution mechanisms in cases of recovery, and put in place preventive mechanisms by way of improved screening of loans.



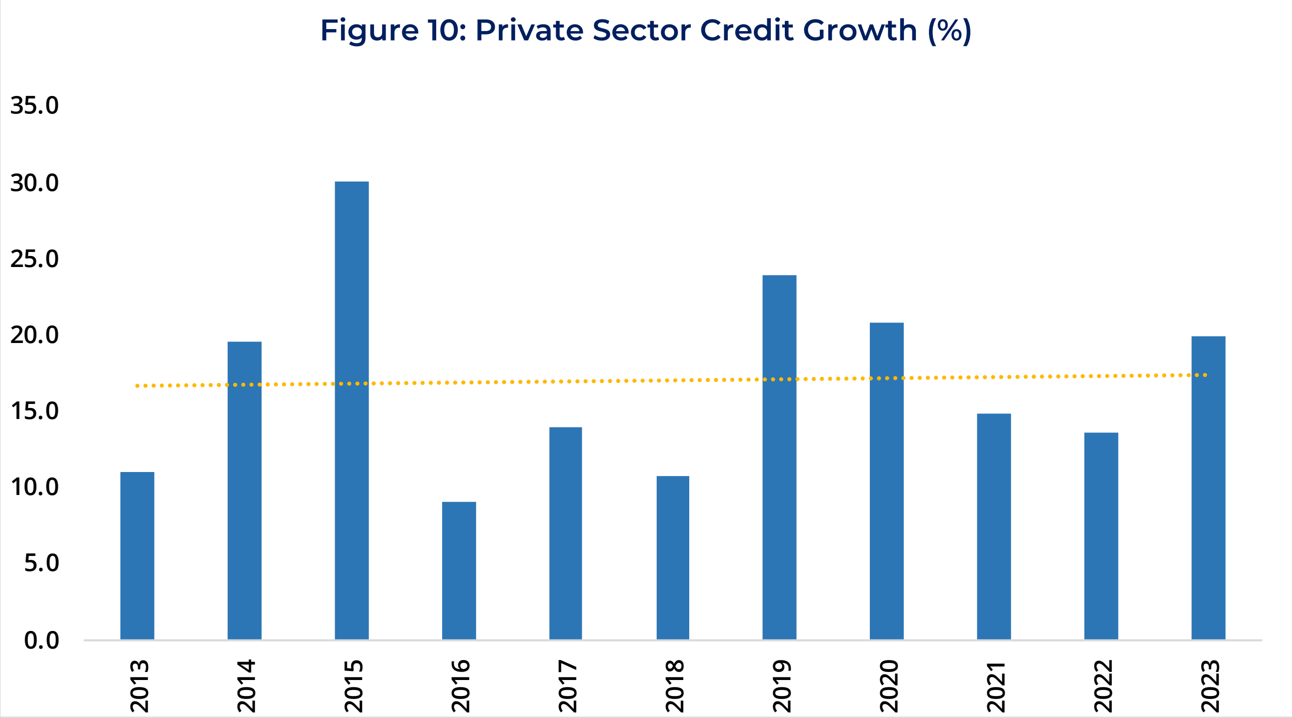


Source: NBR

5 NBR (2023), *Quarterly Financial Stability Committee Meeting Press Release*, August.

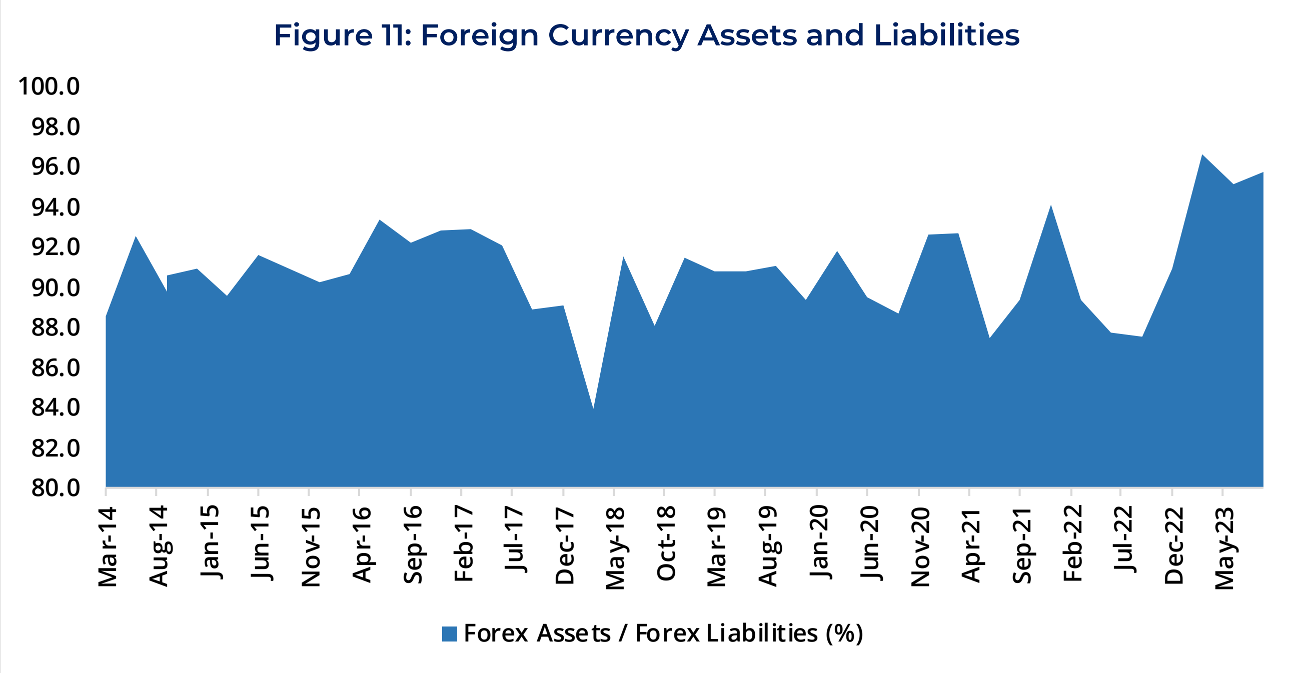
6 Desire, M. J., & Patrick, M. M. (2020). Effect of Credit to Private Sector on Gross Capital Formation in Rwanda (2004-2016). *International Journal of Innovative Research and Development*, Vol. 9(4). pp. 90 – 96

7 IMF (2021), "*Resolving Nonperforming Loans in Sub-Saharan Africa in the Aftermath of the COVID-19 Crisis*", Departmental Paper Series, DP/2021/014



*Source: NBR; *2023 figures are up to September*

In pursuit of the stability agenda, the banking industry has consistently matched foreign exchange assets with foreign exchange liabilities, with sufficient buffer to allow for the market to absorb any shocks arising from external imbalances **(Figure 11)**. The industry is seized of the challenges associated foreign currency volatility, as has been the case since the beginning of 2022.



Source: RBA Data from all Commercial Banks

While commercial banks have the fiduciary responsibility of ensuring that their profit seeking behavior does not jeopardize foreign exchange market stability, the NBR maintains regulatory oversight. The NBR acknowledges that under a liberalized foreign exchange regime, the dynamic nature of the market could result in volatility and risky behavior. That is the basis upon which the central bank has issued detailed regulations to govern foreign exchange operations[8].

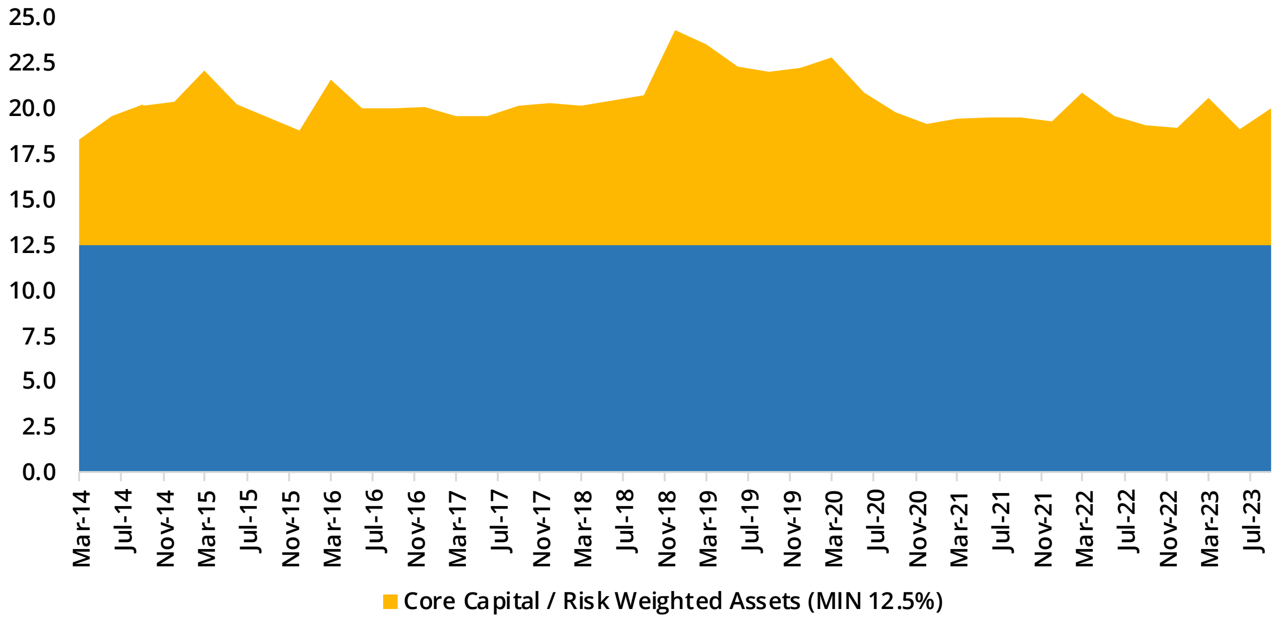
Even with the regulations, there is implicit market tension between intermediaries – banks and deposit taking microfinance banks on the one hand, and foreign exchange bureaus and other institutions – that are authorised by the NBR to deal in foreign exchange. On the back of the foreign exchange demand – supply imbalance occasioning pressure on the foreign exchange market, market power leans more towards the supply side.

Amidst the foreign exchange shortage, those in export business – therefore foreign exchange earners – are incentivized to seek the best deal in the market. Such sellers are continuously in search of attractive rates. Foreign exchange bureaus, keen on business growth, are amenable to offering competitive rates, in the process inviting a response from banks and deposit-taking microfinance institutions to obviate losing market share.

Additionally, there is pressure on the local currency arising from speculative switching of deposits from Rwanda Franc (RWF) deposits to USD deposits. With foreign currency outflows outpacing inflows, the local currency: foreign currency deposit switching augments other speculative practices and ends up entrenching the depreciation bias. A gradual adjustment of the nominal exchange rate of the local currency vis-à-vis major currencies that is devoid of volatility, has been seen as necessary in correcting the economy's external position given the slow pace of fiscal consolidation and limitations in monetary policy transmission[9].

The NBR is no doubt keenly watching developments in the foreign exchange market in line with its mission of ensuring price stability and sound financial system, cognizant of the limitations confronting it. Foreign exchange market dynamics have both macro stability and financial stability dimensions that the NBR is navigating. The challenges to market stability that can potentially arise from the dynamics around the domestic and foreign currency assets and liabilities interplay in the banking industry are obviated by the adequate capitalization of banks, with sufficient capital buffers **(Figure 12)**

Figure 12: Capital Adequacy



***Source:** RBA Data from all Commercial Banks*

8 See *REGULATION N° 42/2022 OF 13/04/2022 GOVERNING FOREIGN EXCHANGE OPERATIONS*

9 See IMF (2023). *The 2023 Article IV Review and Second Review under the Policy Coordination Instrument and Resilience and Sustainability Facility Arrangement.*

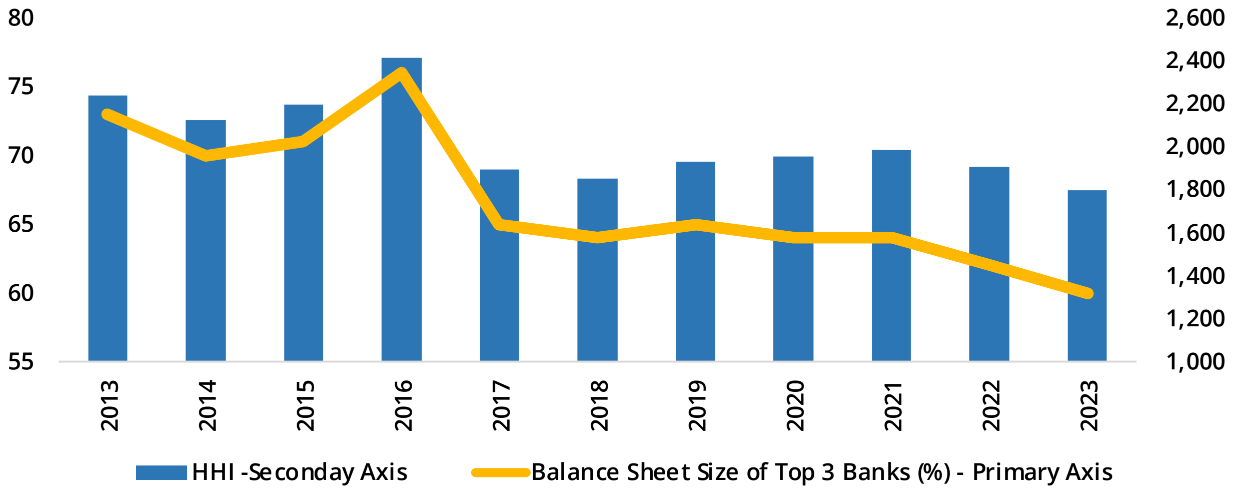
Chapter 4: Market Contestability

The current state of the banking industry in Rwanda reflects an evolving landscape shaped by the strategic objective of the markets players in response to competition dynamics. The growth in the industry and the potential for further development has been bolstered by opportunities for expansion through mergers and acquisitions.

The experience of mergers and acquisition in the banking industry is varied depending on the initial conditions of the market setup. When mergers lead to a more concentrated market, they typically result in rivals increase their post mergers markups. Consistent with increases in market power, the effects are evident when pre-merger concentration is high, when competitors are few, and when relevant markets are national[10].

The Rwandan banking industry presents an interesting case whereby on the backdrop of increasing assets, stable net interest margins, and cautious risk-taking approach, the market is less concentrated as more mergers and acquisitions take place. The combined balance sheet size of the top three banks as a share of the industry balance sheet declined from a high of 76.0% in 2016 to 60.0% by September 2023 **(Figure 13)**. Similarly, Herfindahl-Hirschman Index (HHI) shows that the market is becoming less concentrated even as mergers and acquisitions happen[11].

Figure 13: Market Concentration



Source: RBA Data from all Commercial Banks

The benefits of an open financial sector are evident in the case of Rwanda. The underlying policy of open and liberalised economy is premised on the need to promote market competitiveness on the back of deregulated interest rates and market-based exchange rate. The objective of promoting competition by way of encouraging new market entrants is to supports efficiency gains[12].

The efficiency gains in the banking industry that have resulted in the declining cost to income ratio **(Chapter 3**) is backed by the mix of market players comprised of strong domestic players, regional banks and Pan-African banks **(Figure 14)**. While higher market concentration does not necessarily imply less competition and less concentration does not necessarily translate to more competition[13], it is increasingly becoming evident that the emerging banking industry through the mergers and acquisitions is positively shaping market contestability.

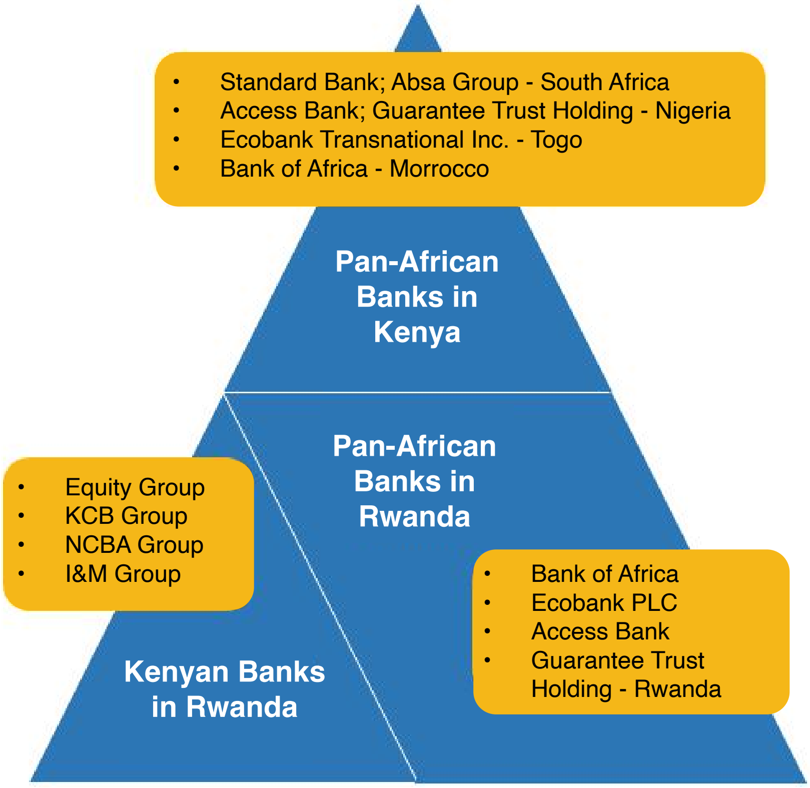
10 Stiebale, J. and Szücs, F. (2022). "Mergers and market power: Evidence from rivals' responses in European markets", *The RAND Journal of Economics*, 53(4). pp. 678 – 702.

11 $\text{HHI} = \sum_{i=1}^{n} MS_i^2$;where n= number of banks and MS is the market share of each bank. The higher the HHI, the more concentrated the market.

12 Ariss, R. T. (2010). *"On the implications of market power in banking: Evidence from developing countries"*, Journal of Banking & Finance, 34 (4), pp. 765 – 775.

13 It is a long-established argument that the relationship between the extent of market power and competition is tenuous. See, for instance, Nathan, A. and Neave, E.H. (1989). "Competition and contestability in Canada's financial system: empirical results". *Canadian Journal of Economics*,22(3), pp. 576-594.

Figure 14: The Regional Mix of Banks



The evident prominence of the Kenyan-based banks in the Rwandan market – more than is the case in either EAC economies where the same banks have subsidiaries – is attributed to three factors[14]. One, the banks seeking cross border opportunities have strong institutional frameworks that fit the requirements of a discerning regulator in the destination market. Two, beyond institutional quality, these banks are exploiting their relative efficiency through expansion into a market with growth potential. Three, the fact that they are subject to intense market competition at the source country relative to the destination is an allure factor.

The mergers and acquisitions are motivated by the pursuit of economies of scale that comes with an expanded customer base. As a growth strategy, these developments are accompanied by product diversification and the strengthening of specific market segments that have growth potential. The observed growth is ostensibly anticipatory of regulatory dynamics especially around capitalization requirements meant to sustain the soundness of the banking system as confirmed by the NBR[15].

While the extent of market concentration is lesser even on the back of mergers and acquisitions, the small banks – big banks dichotomy is still at play in the understanding of possible systemic risks that may arise from clusters of banks. Recent knowledge points to the importance of clusters in possible systemic risks as opposed to the conventional assessments based on size and interconnectedness of the banking system[16]. Portfolio similarities amongst individual banks is observed to be stable and driven by big banks. Equally stable is the portfolio similarity among the small banks as a cluster, pointing to the possibility of exposure to common risks that could be impactful than when banks' exposure is considered from the perspective of individual banks.

14 Kodongo O., Natto, D and Biekpe, N. (2015). "Explaining cross-border bank expansion in East Africa", *Journal of International Financial Markets, Institutions and Money*, 36, pp. 71 – 84.

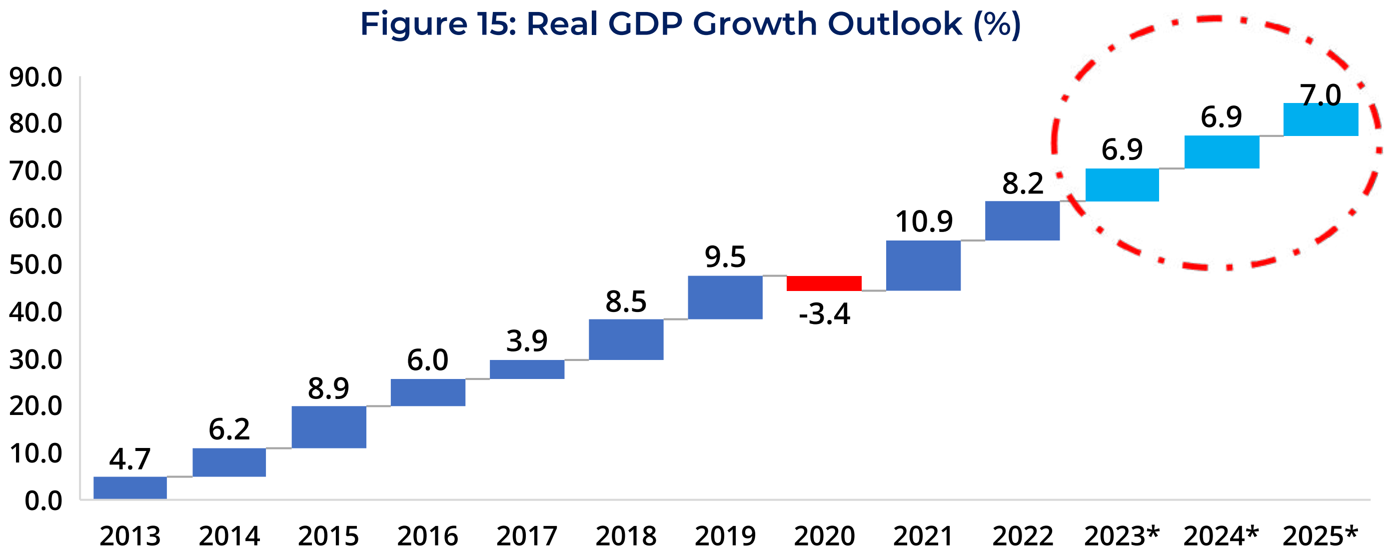
15 NBR (2024). "Monetary Policy and Financial Stability Statement", March.

16 Ntirushwamaboko, D., Mugenzi, P. and Nyalihama, C. (2021). *"Assessing the Systemic Importance of Banks in Rwanda using Portfolio Similarity and Clustering Methods"*. AERC Working Paper Series; CF006.

Chapter 5: Outlook

Based on the foregoing analysis, it is clear that the fortunes of the banking industry and that of the broader economy are intertwined. The increasing embeddedness of the industry to the fabric of the Rwanda economy implies that it will continue to be shaped by both macroeconomic policies, the performance of key sectors of exposure and the underpinning regulatory environment.

The growth trajectory of the banking industry assets as a share of GDP will likely be sustained, cognisant of the positive outlook of the Rwandan economy with regard to real output growth **(Figure 15)**. The economy's projected medium-term growth represents a consolidation of the post COVID-19 gains. In line with the positive path of the banking industry assets as a share of GDP, individual market players are anticipated to maintain the balance between appropriate risk taking that protects asset quality and the pursuit of profitability.



*Source: : IMF World Economic Outlook Database; *= projections*

To the extent that growth in private sector credit by banks has remained positive, firms and households will be increasingly relying on formal financing sources. In the process, the opportunity cost of informality – mainly in terms of credit constraints – will become lesser. The continuous albeit gradual shift away from informality as enabled by the banking industry is supportive of raising the aggregate size of the formal economy.

Associated with the increase in the banking industry assets is the anticipated continued growth in profitability. Even with a conservative approach, the banking industry is registering health returns on assets and equity, underpinned by stable interest rate margins and decreasing cost to income ratio. That speaks to the focus that banks have in boosting their efficiency through deployment of technology.

The outlook of continued profitability will likely shape expectation of the benefits of a stable and profitable banking industry. The matching of the shareholder value to customer benefits is increasingly being embedded in the market dynamics. While the stability in the interest margins is anticipated to be sustained, the industry will be under focus on whether the benefits of technology that has spurred product innovation will transition from convenience to pricing. In that regard, the role of maker competition as shaped by the mergers and acquisitions that have taken place in the banking industry will be critical.

As the economy is projected to remain strong, the low and generally declining levels of NPLs as a share of gross loans that reflects the good quality of the banking industry's assets is anticipated to be sustained. As banks manage their asset books by way of prioritizing the assessment of customers' capacity to repay, the need to continuously fine-tune resolution strategies as well as prevent the accumulation of arrears remains critical.

The balance between the compelling need to protect the quality of assets through the cautions risk-taking and the essence of allocating credit in line with the economy's needs is vital. It is critical to determine the threshold below with the decline in loans to deposition (a proxy for preference of liquidity to profitability) and a similar trend in yield on advances (pointing to the increase of advances to less riskier assets) will be counterproductive.

As banks in Rwanda navigate the balance between risk management and asset growth, it is becoming increasingly important for them to deliberately embed approaches that promote sector, demographic and gender considerations. Future issues of the SBIR will focus on these aspects.

The evidently positive prospects of the Rwanda Banking industry will continue to be shaped by emerging opportunities and risks linked to climate change and the embracing of technology. These aspects have been flagged by the RBA Research Centre and will be areas of focus for future in-depth analysis. The pace of entrenching Environmental Social and Governance (ESG) principles as a business imperative will continue picking as environmental risks become prominent. Similarly, Fintech will continue shaping business practices from products, operational and regulatory standpoints.

Beyond the conventional Fintech, the inevitability of Artificial Intelligence (AI) as a disruptor is gaining prominence. Multilateral organisations such as the Bank of International Settlement (BIS) have invested in the understanding of (AI) on financial stability[17]. The BIS makes the case that the increasing prominence of AI has implications for financial systems and their stability, as well as for macroeconomic outcomes by way of changes in aggregate supply (through productivity) and demand (through investment, consumption and wages). From a regulatory standpoint, central banks are seen not just as keen observers, but also as users of AI. It follows therefore that banks in Rwanda, like in other markets, are anticipated to consider AI as the next frontier is business practice.

17 BIS (2024). BIS Annual Economic Report, July. [BIS Annual Economic Report 2024]

Acknowledgement

This report has benefited from the partnership between Rwanda Bankers Association and Access to Finance Rwanda that facilitated the establishment of the RBA Research Centre.

The **Rwanda Bankers' Association (RBA)**, established in **2009**, is an organization representing licensed banks in Rwanda. Its main objectives include being the voice for non-competitive banking issues and promoting professional standards. The National Bank of Rwanda, though not a member, is often invited to RBA meetings and activities.

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